BEFORE

THE PUBLIC SERVICE COMMISSION OF

SOUTH CAROLINA

DOCKET NO. 2000-0091-E – ORDER NO. 2000-850

OCTOBER 20, 2000

IN RE: Application of Lockhart Power Company for an Increase in Electric Rates and Charges.	))))	ORDER APPROVING RATES AND CHARGES

INTRODUCTION

This matter comes before the Public Service Commission of South Carolina ("Commission") by way of an Application filed by Lockhart Power Company ("Lockhart" or "Company") whereby Lockhart proposed changes in the rates and charges for retail electric service provided by Lockhart. Pursuant to S.C. Code Ann. Section 58-27-860 (Supp. 1999), Lockhart, by letter dated February 15, 2000, notified the Commission that it would seek changes in its retail electric rates. Thereafter, Lockhart on April 20, 2000, filed its Application setting forth the proposed changes in rates and charges. According to Lockhart's Application, the proposed rates and charges contained in the Application would produce an overall increase in revenues of $512,882 over the retail revenues for the twelve-month period ending August 31, 1999. These additional revenues represent approximately a 4.45% increase in Lockhart's revenues attributable to Lockhart's electric retail operations for the twelve-months ending August 31, 1999.

According to the Application, Lockhart has been making investments to improve the operations of its generation, transmission and distribution systems as well as relicensing its hydroelectric facility. Consequently, according to the Application, Lockhart's return on rate base for its retail operations is only 7.37% for the twelve months ended August 31, 1999. According to the Application, Lockhart has proposed rates which would produce a rate of return on retail rate base of 11.25% during the test year after appropriate pro forma adjustments. Further, according to Lockhart's Application, a return on retail rate base of 11.25% is a fair and reasonable rate of return for Lockhart. Also, Lockhart intends to collect from its retail customers during the first month the proposed rates are in effect the unbilled revenue resulting from Lockhart's Purchased Power Adjustment Clause, the mechanics of which create a one-month delay in collection.

The Commission's Executive Director instructed Lockhart to cause to be published a prepared Notice of Filing and Hearing once a week for three consecutive weeks in newspapers of general circulation in the areas affected by the Application. The Notice of Filing and Hearing indicated the nature of Lockhart's Application and advised all interested parties desiring to participate in the proceedings of the manner and time in which to file the appropriate pleadings for inclusion in the case. Lockhart was also required to notify directly all customers affected by the proposed rates and charges. Thereafter, Lockhart furnished affidavits demonstrating that the Notice of Filing and Hearing had been duly published in accordance with the instructions of the Executive Director. In addition, Lockhart certified that a copy of the Notice of Filing and Hearing had been mailed to each customer affected by the rates and charges proposed in the Company's Application.

A Petition to Intervene was filed on behalf of the Consumer Advocate for the State of South Carolina ("Consumer Advocate").

Thereafter, pursuant to Notice provided in accordance with applicable provisions of law and with the Commission's regulations, a public hearing on the matters asserted in Lockhart's Application was held on August 30, 2000. M. John Bowen, Jr., Esquire represented Lockhart; Elliott F. Elam, Jr., Esquire represented the Consumer Advocate; and Florence P. Belser, Deputy General Counsel, and Jocelyn D. Green, Staff Attorney, represented the Commission Staff. The record from the hearing consists of testimony from eight witnesses and ten hearing exhibits. Lockhart presented as witnesses Leslie S. Anderson, Charles R. Parmelee, Paul W. Inman, and James H. Seay, Jr., and the Commission Staff presented as witnesses Dr. James E. Spearman, Sharon G. Scott, Eddie Coates, and A.R. Watts.

FINDINGS OF FACT

Based upon the evidence of record from this proceeding, the Commission makes the following findings of fact. The discussions of supporting evidence and associated conclusions regarding each Finding of Fact are contained in subsequent sections of this Order.

1. Lockhart is a public utility operating in South Carolina where it is engaged in the generation, transmission, distribution, and sale of electricity to the public for compensation. Lockhart's retail electric operations in South Carolina are subject to the

jurisdiction of this Commission pursuant to S.C. Code Ann. Section 58-27-10, et seq. (1976), as amended.

2. The test period established for the purposes of this proceeding is the twelve-month period ending August 31, 1999, adjusted for certain known and measurable changes.

3. Lockhart is seeking approval of rates and charges for its South Carolina retail electric operations which would produce additional annual revenues of $512,882.

4. Lockhart's presently approved rates and charges, as adjusted and allocated to South Carolina retail electric operations, produced Operating Revenues of $11,249,954.

5. The reasonable test year Operating Expenses for Lockhart's South Carolina retail electric operations, after pro forma adjustments and prior to the effect of the proposed increase approved herein, are $10,467,560.

6. The appropriate Operating Expenses for Lockhart's South Carolina retail electric operations after approval of the rates and charges herein are $10,765,308.

7. Lockhart's retail electric Total Income for Return after accounting and pro forma adjustments and after the effect of the increase in the rates and charges approved herein is $1,295,139.

8. Lockhart's original cost rate base allocated to South Carolina retail electric operations for the test year after approved accounting and pro forma adjustments is $11,769,244.

9. The capital structure utilized by the Commission in this proceeding for the determination of the fair overall rate of return is the existing capital structure of Lockhart which is comprised of 100% equity with no debt.

10. The fair rate of return on common equity, which Lockhart should be allowed a reasonable opportunity to earn, is 11.00%.

11. Based upon the specific findings and conclusions herein, Lockhart's annual revenue requirement for its South Carolina retail electric operations is $12,043,751, which will allow Lockhart a reasonable opportunity to earn an 11% rate of return on its jurisdictional rate base which the Commission finds just and reasonable. The rates approved herein are intended to produce revenues for Lockhart's South Carolina retail electric operations of $793,797, after accounting and pro forma adjustments..

12. The cost of service methodology, rate design, and rate schedules as proposed by Lockhart are appropriate and should be adopted for the purpose of this proceeding.

EVIDENCE SUPPORTING FINDINGS OF FACT AND CONCLUSIONS

1. **Lockhart is a public utility operating in South Carolina where it is engaged in the generation, transmission, distribution, and sale of electricity to the public for compensation. Lockhart's retail electric operations in South Carolina are subject to the jurisdiction of this Commission pursuant to S.C. Code Ann. Section 58-27-10, et seq. (1976), as amended.**

The evidence to support this finding concerning the legal and operational descriptions of Lockhart and its jurisdictional business is contained in the Application submitted. By its Application, Lockhart acknowledges that it is a public utility operating in South Carolina and further acknowledges that its rates for electric service to the public (i.e. retail rates) are made, fixed, and allowed by this Commission. (Application, p. 1)

2. **The test period established for the purposes of this proceeding is the twelve-month period ending August 31, 1999, adjusted for certain known and measurable changes.**

The evidence for this finding is contained in Lockhart's Application and in the testimony and exhibits of Lockhart's witnesses. The Application and its accompanying exhibits were based upon a test year consisting of the twelve-months ending August 31, 1999. (Application, P. 1 and Exhibits to Application.)The witnesses for the Commission Staff likewise offered their evidence within the context of the same period.

A fundamental principle of the ratemaking process is the establishment of a test year period. The purposes of the test year are to provide a definite period to audit and to provide a definite period on which to estimate future revenue requirements. The reliance of the test year concept, however, is not designed to preclude the recognition and use of other historical data that may precede or postdate the selected twelve-month period.

Integral to the use of the test year, representing normal operating conditions to be anticipated in the future, is the necessity to make normalizing adjustments to the historic test year figures. Only those adjustments which have reasonable and definite characteristics and which tend to influence reflected operating experience are made to give proper consideration to revenues, expenses and investments. Parker v. South Carolina Public Service Commission, et al. 280 S.C. 310, 313 S.E.2d 290 (1984). Adjustments may be allowed for items occurring in the historic test year, but which will not recur in the future, or to give effect to items of an extraordinary nature by either normalizing or annualizing such items to reflect more accurately their annual impact, or to give effect to any other item which should have been included or excluded during the historic test year.

Based upon the evidence of record, the Commission concludes that the twelve-months ending August 31, 1999, is the reasonable period upon which to make our ratemaking determinations herein. The relevant evidence of record and Lockhart's discovery responses have been submitted using the twelve-month period ending August 31, 1999.

3. **Lockhart is seeking approval of rates and charges for retail electric operations which would produce additional annual revenues of $512,882.**

In its Application, Lockhart asserts that the rates proposed in the Application will produce an overall increase in revenues of 4.45% or a $512,882 annual increase over the test year retail revenue. (Application, p. 2, ¶ 4.) The revenues reflect a lowered Purchased Power base rate level resulting from an anticipated reduction in Purchased Power expenses. Staff also calculated the increase in revenues from the proposed rates as $512,882. (Prefiled Testimony of Coates, p. 2, ll. 1-10.)

4. **Lockhart's presently approved rates and charges, as adjusted and allocated to South Carolina retail electric operations, produced Operating Revenues of $11,249,954.**

The evidence supporting the finding concerning the adjusted level of per book Operating Revenues of $11,249,954 for South Carolina retail operations is found in the testimony and exhibits of the Staff's witnesses. (Hearing Exhibit No. 8, p. 6, Audit Exhibit A.) The Commission herein adopts adjustments to South Carolina retail operating revenues which result in a decrease of $280,915. The individual adjustments are discussed below.

(a) **Purchased Power** - Both Lockhart and the Staff proposed a reduction to system revenues to reflect a pro forma decrease in Purchased Power costs. Lockhart proposed an adjustment of ($510,941) with ($312,481) being attributable to South Carolina retail operations. Staff proposed an adjustment of ($442,618) with ($270,696) being attributable to South Carolina retail operations. The difference between Lockhart's and Staff's adjustments represents Staff's difference of opinion on the determination of the proper amount for generator rewindings, generation due to drought shortfall, and lost generation due to FERC required water by-pass. (Prefiled Testimony of Watts, p. 3, ll. 8-14; Hearing Exhibit No. 10, Part B, p. 2; Hearing Exhibit No.8, Audit Exhibit A-1, p. 1 of 12; Application, Attachments A3-3, A3-4, A3-5, A3-6, and A3-7.) Staff made its adjustment to more accurately reflect the total power that could be expected to be produced, at a given river flow rate, from this additional capacity of rewound generators, not just at full capacity of the generators. Lockhart's adjustment reflects generation only when the generators are available to run at full capacity. The Commission finds that Staff's adjustment is more appropriate. The generators will not always be operated only at full capacity, and the Commission finds it is more appropriate to adopt the adjustment which more accurately simulates the actual operation of these facilities rather than an adjustment that reflects output only when the generators run at full capacity.

(b) **Reclassification of Revenue** - Both Lockhart and the Staff proposed an adjustment of $5,511 to reclassify Industrial Class Revenues to Other Operating Revenues. This amount of $5,511 was generated from charges for facilities provided for interconnection with Pacolet Hydro, a small power producer providing its output to Lockhart Power. This amount was incorrectly applied to Industrial Revenues. (Prefiled Testimony of Watts, p. 3, ll. 15-24; Hearing Exhibit No. 10, Part. B, p. 2; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 1 of 12.) The transfer of this amount to Other Operating Revenues has a net zero (0) effect on the revenue account. The Commission finds this adjustment reasonable as this adjustment corrects the classification of revenues and hereby adopts this adjustment, even though this adjustment has a net zero effect on the revenue account.

(c) **Contract Settlement** - Lockhart proposed an adjustment to remove $9,250 from test year Operating Revenues. Staff concurred with Lockhart's adjustment. This item is a one-time, non-recurring settlement payment to Lockhart from a former industrial customer. (Prefiled Testimony of Watts, p. 3, ll. 21-24; Hearing Exhibit No. 10, Part B, p. 2; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 1 of 12.) As this item involves a one-time settlement that is non-recurring, the Commission adopts the adjustment to remove this amount from test year Operating Revenues. (Prefiled Testimony of Watts, p. 3, ll. 21-24; Hearing Exhibit No. 10, Part B, p. 2; Hearing Exhibit No.8, Audit Exhibit A-1, p. 1 of 12.)

(d) **Franchise Fees** - Lockhart proposed an adjustment to remove $1,470, of which $969 is attributable to South Carolina retail operations, from test year Operating

Revenues. The adjustment was proposed to remove from test year Operating Revenues the amount that the Town of Pacolet Mills previously charged Lockhart for its franchise fee. Staff agreed with the adjustment. Lockhart is approved by Commission Order No. 93-195, dated March 1, 1993, to pass-through the franchise fee to the residents of Pacolet Mills. (Prefiled Testimony of Watts, p. 3, l. 25 – p. 4, l.3; Hearing Exhibit No. 10, Part B, p. 2; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 2 of 12; Application, Attachment A3-13.) Lockhart may only apply this pass-through charge of the franchise fee to the residents of Pacolet Mills. Lockhart and the Staff agree that this adjustment is necessary to remove this remaining portion of the franchise fee from revenues and the cost study. (Prefiled Testimony of Watts, p. 3, l. 25 – p.4, l.3; Hearing Exhibit No. 10, Part B, p. 2; Hearing Exhibit No.8, Audit Exhibit A-1, p. 2 of 12.) The Commission finds that amounts collected pursuant to the pass-through are not revenues upon which rates may be set. Therefore, the Commission concurs with the reasoning of Lockhart and the Staff to remove this amount from test year Operating Revenues.

Total Effect of Adjustments to Operating Revenues - The result of the above-adopted adjustments decreases per book Operating Revenues by $453,338 for total electric operations and decreases per book Operating Revenues for South Carolina retail operations by $280,915. Lockhart and the Staff show per book Operating Revenues of $17,511,991 for total electric operations and per book Operating Revenues for South Carolina retail operations of $11,530,869. After pro forma and accounting adjustments adopted above, Lockhart has as adjusted Operating Revenues of $17,058,653 for total electric operations and as adjusted Operating Revenues of $11,249,954 for South Carolina retail operations.

5. **The reasonable test year Operating Expenses for Lockhart's South Carolina retail electric operations, after pro forma adjustments and prior to the effect of the proposed increase approved herein, are $10,467,560.**

Adjustments affecting operating expenses were included in the testimony and exhibits offered by witnesses for Lockhart and the Staff. The operating expenses for Lockhart's South Carolina retail operations after the pro forma adjustments adopted herein and prior to the effect of the rate increase approved by this Order are $10,467,560. The specific accounting and pro forma adjustments are discussed below.

(a) **Purchased Power Expense** – Lockhart proposed an adjustment to increase Purchased Power by $179,149, of which $109,997 is attributable to South Carolina retail operations. This adjustment was proposed due to an increase in the Duke Power wholesale rate approved by FERC. The new Duke Power wholesale rate became effective on August 19, 1999. FERC approved the elimination of a .0648 cents per kilowatt-hour credit from Duke's wholesale tariff. This increase in the Duke wholesale rate resulted in increased Purchased Power expense to Lockhart of $179,149, or $109,997 attributable to South Carolina retail operations, on a test year basis. Staff examined the adjustment and recommended approval of the adjustment. (Prefiled Testimony of Watts, p. 4, ll. 4-9; Hearing Exhibit No. 10, Part B, p. 2; Hearing Exhibit No.8, Audit Exhibit A-1, p. 2 of 12; Application, Attachment A3-7.) The Commission finds that this adjustment to Purchased

Power expense is appropriate, as the increased rate will be charged to Lockhart going forward.

(b) **Purchased Power Expense** – Lockhart proposed a reduction to Purchased Power expense of $104,867, of which $62,536 is attributable to South Carolina retail operations. The adjustment is proposed due to increased hydro capacity resulting from the rewindings of two of Lockhart's generating units. The Staff concurred with the premise of the adjustment but disagreed with Lockhart's method in determining the energy rate as well as the level of availability in the calculation. Lockhart, in calculating the increase in power production from the rewinding of the generators, used an availability factor of 11% reflecting production only at times of full unit output in determining the energy component. (Application, Attachment A3-4.) Staff proposed a factor of 17% for the energy portion of the calculation and which yielded an adjustment of ($112,870), of which ($67,455) is attributable to South Carolina retail operations. Staff offered that the energy portion of the calculation should be based on the corresponding average Purchased Power energy costs and stated that the average percent of time that this additional capacity could be used due to waterflow is 17%. Lockhart's use of the 11% factor only takes into account the time when all of the capacity could be used to generate power. Staff also offered that it would be more accurate in determining the energy portion of this adjustment to use the actual average corresponding energy costs from Purchased Power test year data in lieu of the Company's use of an energy rate effective only after August 19, 1999. (Prefiled Testimony of Watts, p. 4, ll. 10-21; Hearing Exhibit No. 10, Part B, p. 2; Hearing Exhibit No.8, Audit Exhibit A-1, p. 2 of 12.

Upon consideration of this adjustment, the Commission finds the Staff's position more appropriate. Power will be produced at times when the generators are not operating at full capacity. Lockhart's adjustment only accounts for the time when it is estimated that the generators will be operating at full capacity while Staff's adjustment reflects average availability for this capacity and includes times when power is generated at levels other than full capacity. Therefore, the Commission concludes that Staff's adjustment more properly and accurately reflects the actual operations of the generators, and the Commission adopts Staff's adjustment.

(c) **Purchased Power Expense** – Lockhart proposed a reduction to Purchased Power expense to address the lost generation due to drought conditions occurring during the test year. Lockhart proposed a reduction of $803,632, of which $493,430 is attributable to South Carolina retail operations. (Application, Attachment A3-5.) Staff agreed with the premise of the adjustment, but Staff used the average energy costs of Purchased Power from the test year to calculate the adjustment. Staff proposed a reduction to Purchased Power expense of $727,793, of which $446,865 is attributable to South Carolina retail operations. (Prefiled Testimony of Watts, p. 4, ll.22-28; Hearing Exhibit No. 8, Part B, p. 3; Hearing Exhibit No. 10, Audit Exhibit A-1, p. 3 of 12.) Upon consideration of this adjustment, the Commission finds Staff's adjustment to be more reasonable. Staff's adjustment utilized the average Purchased Power energy costs where Lockhart's adjustment used an inaccurate average of the monthly test year Purchased Power energy rates. (Prefiled Testimony of Watts, p. 4, ll. 22-28.) As with the adjustment to Purchased Power due to the generator rewindings, the Commission concludes that the adjustment utilizing the average Purchased Power energy costs more properly reflects the actual operations than the adjustment that used the average of the monthly Purchased Power energy rates.

During the proceeding, there were questions proffered and concerns expressed by the Commission regarding the use of only six years (1992-1997) as the base period for determining this adjustment. It was conveyed through these inquiries that use of such a short time frame may not be sufficient to capture adequate data for the base period in this case. Due to seasonal, annual and inter-annual climatic patterns and the resultant variability in streamflow, the use of six years of streamflow data does not provide a statistically representative base period. An appropriate period must be utilized to accurately reflect the recurrence probability of the test year within the extended streamflow record. Inclusion of many years of flow data is necessary to describe the statistical distribution which results from climatic extremes providing a more representative base period from which to compare.

As a result of these discussions, the Commission requested a late-filed exhibit from Lockhart on the Kleinschmidt Associates Model ("KA Model"), which utilized a twenty-four year (1970 – 1994) period to estimate the historical daily energy generation assuming current, improved turbine and motor efficiencies. Lockhart modified the model as requested and provided the late-filed exhibit. (See, Hearing Exhibit No. 5.) Lockhart's summary analysis indicates an insignificant difference in the ensuing adjustments that result from the utilization of either the six-year or twenty-four year period. Lockhart stated that the resulting difference in the adjustments to South Carolina retail revenues is less than one hundredth of a cent, which is less than the units as reflected on Lockhart's retail rates.

The KA Model requires the use of numerous engineering assumptions. These dynamic variables include a pro-rated mean daily flow at Lockhart station, net head, head loss, unit efficiencies, and forced and scheduled outage rates. The accuracy of the KA Model output is directly related to the accuracy of these variables. If the inputs are flawed, the results would be of questionable value at best. When possible, a model should be validated and calibrated by comparing model output to actual empirical data. Discrepancies were found between the KA Model results, when compared to Lockhart's actual generation during the overlapping three years (i.e.1992-1994), calling into question the accuracy of the KA Model. Actual generation for these three years was both greater than and less than that estimated by the KA Model. The actual generation in this case should always be less than the generation that the KA Model predicts since the actual capacity was 15.6 MW during 1992-1994 whereas the KA Model used an input of 17.4 MW.

Witnesses for both Lockhart and the Staff acknowledged that a reliable model incorporating a significant number of years would produce a more accurate estimate on which to adjust the test year. Because the reliability of the KA Model has not been sufficiently substantiated, the Commission finds that the Staff adjustment is the appropriate adjustment to use in this case. However, in future filings which include this type adjustment, Lockhart shall use an appropriate model based on standard engineering practices to include a statistically representative period of record while providing adequate consideration to modified run-of-river operations and downstream water release requirements.

(d) **Purchased Power Expense** – Lockhart made an adjustment to Purchased Power expense to correct for lost generation due to FERC required water by-pass. Lockhart's new operations license requires that Lockhart pass a specified amount of water in the Lockhart bypass reach. As a result, Lockhart will lose the ability to generate electricity due to this bypass and must purchase that lost power from Duke Power. Lockhart proposed an increase to Purchased Power expense of $218,409, of which $132,284 is attributable to South Carolina retail operations. (Application, Attachment A3-6; Hearing Exhibit 8, Audit Exhibit A-1, p. 3 of 12.) Staff agreed with the need for the adjustment but as with the adjustments to Purchased Power expense regarding the generator rewindings and the shortfall due to drought conditions, Staff used the average test year Purchased Power energy cost to determine the appropriate energy portion of the Staff adjustment. Staff proposed an adjustment of $218,896, of which $132,583 is attributable to South Carolina retail operations. (Prefiled Testimony of Watts, p. 4, l. 29 – p. 5, l. 5; Hearing Exhibit 10, Part B, p. 3; Hearing Exhibit 8, Audit Exhibit A-1, p. 3 of 12.) The Commission concludes that Staff's adjustment which utilizes the average test year Purchased Power energy cost more closely reflects actual operations than Lockhart's adjustment which utilized an out-of-period Purchased Power energy rate from the month of February 2000.

(e) **Wage Increase** - Lockhart proposed to increase Operating and Maintenance ("O&M") expense to account for a 3.75% increase that became effective for all hourly employees. This increase became effective after the end of the test year, but Lockhart seeks inclusion of this wage increase in the rate case. (Application, Attachment A3-10.) Lockhart proposed an increase to O&M expense of $36,005, of which $26,845 is attributable to South Carolina retail operations. Staff proposed an adjustment to O&M expense of $33,312, of which $23,198 is attributable to South Carolina retail operations to account for the hourly employees' wage increase.. Staff also proposed an adjustment to Administrative and General expense of $26,876, of which $21,907 is attributable to South Carolina retail operations, to account for administrative employees who received a wage increase. During Staff's review of the proposed adjustment, Staff found that the administrative employees had also received a wage increase. Thus, Staff included the wage increase for the administrative employees in the proposed adjustment as a known and measurable change to test year operations. With its adjustments to account for the wage increase to hourly and administrative employees, Staff also made a corresponding adjustment to Income Tax expense for ($22,450), of which ($16,824) is attributable to South Carolina retail operations. (Prefiled Testimony of Scott, p. 6, ll. 8-11; Oral Testimony of Scott at Hearing; Hearing Exhibit No.8, Audit Exhibit A-1, p. 4 of 12.) Upon consideration of this adjustment, the Commission finds the Staff's adjustment appropriate. Even though the wage increases occurred after the test year, the wage increases to both the hourly employees (O&M expense) and administrative employees (Administrative and General expense) are known and measurable changes to the test year operations. Thus, the Commission adopts this known and measurable out-of-test year adjustment.

(f) **Wage Increase** – Associated with the wage increase for hourly employees, Lockhart made an adjustment to O&M expense for fringe benefits. Lockhart's adjustment was to increase O&M expense by $4,628, of which $3,451 is attributable to South Carolina retail operations and a decrease to Income Taxes of $1,726, of which $1,287 is attributable to South Carolina retail operations. Staff likewise made an adjustment to O&M expense for fringe benefits associated with the wage increase for hourly employees and also made an adjustment to Administrative and General expense for fringe benefits associated with the wage increase given to administrative employees. Staff's adjustments are a $3,761 increase to O&M expense, of which $2,619 is attributable to South Carolina retail operations; a $3,507 increase to Administrative and General expense, of which $2,859 is attributable to South Carolina retail operations; and a decrease to income tax expense of $2,711 of which $2,043 of the decrease is attributable to South Carolina retail operations. (Prefiled Testimony of Scott, p. 6, ll.12-16; Oral Testimony of Scott at Hearing; Hearing Exhibit No. 8, Audit Exhibit A-1, p 4 of 12; Application, Attachment A3-10, A3-11.) As the Commission has determined that the wage increase for both hourly and administrative employees should be included in this rate case as a known and measurable out-of-test year expense, the Commission adopts Staff's adjustment to provide for a matching of expenses for fringe benefits for both the hourly and administrative employees.

(g) **Wage Increase** – Also associated with the wage increase for hourly employees, Lockhart proposed an adjustment to account for FICA taxes. Lockhart proposed an increase to Taxes Other Than Income of $2,886, of which $2,152 is attributable to South Carolina retail operations, and a decrease to Income Tax expense of $1,076, of which $803 of the decrease is attributable to South Carolina retail operations. Lockhart's adjustment only covered the wage increase for hourly employees. Staff's adjustment, which includes the wage increase to hourly and administrative employees, amounted to an increase in Taxes Other Than Income of $4,261, of which $3,473 is attributable to South Carolina retail operations, and a decrease to Income Tax expense of $1,589, of which $1,295 of the decrease is attributable to South Carolina retail operations. (Prefiled Testimony of Scott, p. 6, ll. 17-19; Oral Testimony of Scott at Hearing; Hearing Exhibit No. 8, Audit Exhibit A-1, p 4 of 12; Application, Attachment A3-10, A3-11.) As the Commission has determined that the wage increase for both hourly and administrative employees should be included in this rate case as a known and measurable out-of-test year expense, the Commission adopts Staff's adjustment to provide for a matching of expenses for FICA taxes for both the hourly and administrative employees.

(h) **Fish Habitat Improvement** – Lockhart proposed an adjustment of $28,263 to O&M expense, of which $17,077 is attributable to South Carolina retail operations, for an annual payment Lockhart must make to the South Carolina Department of Natural Resources ("SCDNR") for fish habitat improvement. Lockhart is required to make this payment under the FERC Order Issuing New Major License. The FERC order requires payment of $25,000 in 1997 dollars, adjusted annually by the previous year's consumer price index. The payment is made to SCDNR's Broad River Enhancement Fund to be used for specific needed aquatic resource enhancements. Lockhart calculated its adjustment assuming a 2.7% CPI over a three year period which resulted in an annual average charge of $28,263. (Application, Attachment A3-8.) Staff concurred with Lockhart's adjustment. (Prefiled Testimony of Scott, p. 6, l. 20 – p. 7, l. 2; Hearing Exhibit No.8, Audit Exhibit A-1, p. 5 of 12.) Upon consideration of the proposed adjustment, the Commission finds that it should be adopted. This payment to SCDNR is required by the FERC order licensing Lockhart's hydro facility. As such, this payment is a necessary cost of doing business and is appropriately included in the Company's expenses.

(i) **Non-allowables** – Staff proposed to adjust Administrative and General expense by ($2,238), of which ($1,824) is attributable to South Carolina retail operations. Staff's adjustment is to remove items that Staff considered "non-allowable" for ratemaking purposes. Staff removes expenses such as memorials, flowers, gift certificates, service awards, retirement gifts, one-half of chamber of commerce dues, and image advertising. (Prefiled Testimony of Scott, p. 7, ll. 3-5; Oral Testimony of Scott; Hearing Exhibit No.8, Audit Exhibit A-1, p. 5 of 12.) Lockhart did not propose an adjustment on non-allowables. Upon consideration of this matter, the Commission finds that the Staff's adjustment should be adopted. Items such as those which the Staff removed are items which are not necessary to providing service and should be treated as below-the-line expenses for ratemaking purposes.

(j) **Rate Case Expenses** – Both Lockhart and the Staff proposed an adjustment of $9,363, all of which is attributable to South Carolina retail operations, for amortization of rate case expenses. Rate case expenses amounted to $28,088. (Application, Attachment

A3-9.) Both Lockhart and the Staff proposed a three-year amortization period for the rate case expenses. (Prefiled Testimony of Scott, p. 7, ll. 6-8; Oral Testimony of Scott; Hearing Exhibit No.8, Audit Exhibit A-1, p. 6 of 12; Application, Attachment A3-9.) The Commission finds this adjustment reasonable and hereby adopts this adjustment. The Consumer Advocate questioned Staff witness Scott about the selection of the three-year amortization period rather than another period. Witness Scott stated that Staff had consistently used a three-year amortization period for rate case expenses and saw no reason to deviate from that practice. The Commission notes that other than the question from the Consumer Advocate, the record is devoid of any other reasonable period to use for amortization of rate case expenses. Therefore, the Commission adopts this adjustment proposed by Lockhart and the Staff.

(k) **Depreciation Expense** – Lockhart and the Staff both propose an adjustment for annualized Depreciation expense. The proposed adjustment is an increase to Depreciation expense of $11,817, of which $10,658 is attributable to South Carolina retail operations. Associated with this adjustment is a corresponding adjustment to Income Tax expense of ($4,408), of which ($3,975) is attributable to South Carolina retail operations. (Prefiled Testimony of Scott, p. 7, ll. 9-10; Hearing Exhibit 10, Audit Exhibit A-1, p. 6 of 16; Application, Attachment A3-2.) The Commission finds this adjustment reasonable and adopts this adjustment in this proceeding. This adjustment allows Lockhart a full year of Depreciation expense. The adjustment is computed using the year-end plant balance at the appropriate depreciation rate. By using the year-end plant balance, Lockhart receives a full year's depreciation for plant additions during the test year.

(l) **Transportation Equipment** – Staff proposed an adjustment to O&M expense to correct for over-depreciation of transportation equipment. Staff's adjustment of ($13,367), of which ($11,535) is attributable to South Carolina retail operations, is to remove the depreciation portion of transportation expenses from O&M accounts. Transportation depreciation expenses were not booked in the Depreciation account but were booked to several expense accounts in which the transportation costs are related. In addition, Lockhart claimed more Depreciation Expense than it was entitled to claim. Staff's adjustment corrects the over-depreciation by removing the over-stated amounts from O&M expenses. (Prefiled Testimony of Scott, p. 7, ll. 11-15; Oral Testimony of Scott; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 6 of 12.) The Commission adopts the adjustment proposed by Staff. Lockhart cannot claim more depreciation than it is entitled to claim. As this adjustment corrects for over-stated depreciation as determined by Staff in its audit of Lockhart's books and records, the Commission finds that this adjustment should be approved.

(m) **Amortization of FERC License Expenses** – Lockhart and the Staff propose to amortize the FERC license expense of $924,804 over 40 years, which is the life of the license. This amount amortized over 40 years results in an adjustment to expenses of $23,120, of which $13,968 is attributable to South Carolina retail operations. (Application, Attachment A-2, A3-12; Prefiled Testimony of Scott, p.7, ll.16-18; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 7 of 12.) The Commission finds this adjustment reasonable. Licensing costs are expenses necessary to providing service, and the Commission finds it appropriate to spread the total expense over the life of the license.

(n) **Annual FERC License Fee** – Lockhart proposed to adjust the test year for the annual FERC License Fee. Lockhart calculated an increase of $12,047, of which $7,279 is attributable to South Carolina retail operations. (Application, Attachment A3-2, A3-14.) Additionally, the adjustment is accompanied by a decrease to Income Tax expense of $4,494, of which $2,715 is attributable to South Carolina retail operations. Staff agreed with Lockhart's adjustment. (Prefiled Testimony of Scott, p. 7, ll.19-20; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 7 of 12.) The Commission finds this adjustment proper because it adjusts the per book expenses for actual billed expenses for FERC Administrative Charges and other FERC annual charges. These FERC charges are a cost of business and as such are an expense upon which rates may be set.

(o) **Property Taxes** – Both Lockhart and Staff propose an adjustment to annualize property taxes. The amount of the adjustment is $20,788, of which $16,657 is attributable to South Carolina retail operations, to Taxes Other Than Income expense, with an adjustment of ($7,754), of which ($6,213) is attributable to South Carolina retail operations, to Income Tax expense. (Prefiled testimony of Scott, p. 7, ll. 21-22; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 7 of 12.) The effect of the adjustment is to annualize property taxes on new plant additions after December 31, 1998. The Commission adopts this adjustment, as it is necessary to properly state Property Tax Expense at the end of the test period.

(p) **Revenue-Related Taxes** – Lockhart proposed adjustments to revenue-related taxes associated with the revenue adjustments. Lockhart adjusted Taxes Other Than Income by ($1,744), of which ($1,150) is attributable to South Carolina retail operations, and increased Income Tax expense by $651, of which $429 is attributable to South Carolina retail operations. Staff proposed adjustments of ($1,515), of which ($939) is attributable to South Carolina retail operations, to Taxes Other Than Income, and $565, of which $350 is attributable to South Carolina retail operations, to Income Tax expense. The difference in the adjustment is attributable to Staff's recommended pro forma revenue adjustments. Gross receipts taxes and city taxes are computed using the Company's revenues. (Prefiled Testimony of Scott, p. 8, ll. 1-3; Oral Testimony of Scott from Hearing; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 8 of 12.) As Staff recommended certain pro forma revenue adjustments, Staff also recommended the related adjustments to the tax accounts. The Commission finds the Staff adjustment reasonable and proper. As the Commission adopted Staff's adjustments to revenues, the Commission finds it appropriate to adopt the related adjustments to the tax accounts.

(q) **Pacolet Mills Franchise Fee** – Lockhart and Staff proposed identical adjustments to remove the Pacolet Mills franchise fee from the cost of service. The adjustment reduces Taxes Other Than Income by $1,470, of which $969 of the reduction is attributable to South Carolina retail operations, and increases Income Tax by $548, of which $361 is attributable to South Carolina retail operations. Lockhart's customers in Pacolet Mills are billed directly for this fee, which Lockhart then pays to the town of Pacolet Mills. Lockhart is approved by Commission Order No. 93-195, dated March 1, 1993, to pass-through the franchise fee to the residents of Pacolet Mills. (Application, Attachment A3-13; Prefiled Testimony of Scott, p. 8, ll. 4-6; Hearing Exhibit 8, Audit Exhibit A-1, p. 8 of 12.) This franchise fee is not a cost of service item and is properly removed from cost of service. Therefore, the Commission adopts this adjustment for this proceeding.

(r) **Interest on Customer Deposits** – Staff proposed an adjustment to Interest on Customer Deposits of ($5,219). Staff's adjustment is made to normalize the test year interest on customer deposits by applying the Commission approved interest rate of 8% to the year-end Customer Deposits of $72,666. This resulted in a test year level of $5,813 in the account for Interest on Customer Deposits. Per book Interest on Customer Deposits amounted to $11,032. Thus, Staff proposed the adjustment to reduce Interest on Customer Deposits by $5,219. (Prefiled Testimony of Scott; Oral Testimony of Scott from Hearing; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 8 of 12.) Upon consideration of this adjustment, the Commission finds that this adjustment should be adopted. For ratemaking purposes, expense accounts should be normalized to reflect the actual conditions of the Company. The Company's expense account for Interest on Customer Deposits should correspond to the amount of actual customer deposits being held by the Company.

Total Effect of Adjustments to Operating Expense - The effect of the adjustments adopted above adjust per book Operating Expenses for South Carolina retail operations by ($207,085). Per book Operating Expenses for South Carolina retail operations for the test year amount to $10,674,645. Applying the adjustments approved herein to the per book South Carolina retail operations Operating Expenses results in as adjusted Operating Expenses for South Carolina retail operations of $10,467,560.

6. **The appropriate Operating Expenses for Lockhart's South Carolina retail electric operations after approval of the rates and charges herein are $10,765,308.**

The derivation of Lockhart's operating expenses of $10,765,308 is based upon Findings of Fact Nos. 5, 10, 11, and 12. Operating Expenses, as adjusted, for South Carolina retail electric operations are $10,467,560. (See, Finding of Fact No. 5.) Adjustments associated with the herein approved allowed revenues of $793,797 (See. Finding of Fact No. 12.) were computed for Taxes Other Than Income and for Income Taxes. Staff computed an adjustment of $2,651 for gross receipts and city taxes (Taxes Other Than Income) and an adjustment of $295,097 for Income Taxes. (Hearing Exhibit No. 8, p. 6, Audit Exhibit A.) Adding these adjustments to the as adjusted South Carolina retail operations Operating Expenses results in Operating Expenses after approval of the rates and charges of $10,765,308.

7. **Lockhart's retail electric Total Income for Return after accounting and pro forma adjustments and after the effect of the increase in rates and charges approved herein is $1,295,139.**

The derivation of Lockhart's Income for Return after the effect of the rates approved herein is $1,295,139. This amount was computed using the Operating Revenues after the proposed increase of $12,043,751 less Operating Expenses of $10,765,308 (See, Finding of Fact 6) and adding Customer Growth.

With regard to the Customer Growth calculation, Lockhart and the Staff used the same methodology in computing Customer Growth. However Staff's computation of Net Operating Income differs from that of Lockhart due to differences in pro forma adjustments. This difference results in the difference in the Customer Growth adjustments. (Application, AttachmentA3-2; Prefiled Testimony of Scott, p. 11-12;Oral Testimony of Scott at hearing; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 9 of 12; Hearing Exhibit No. 8, Audit Exhibit A-2.) The Commission adopts the Staff's proposed adjustment for Customer Growth. As the Commission has adopted Staff's accounting adjustments where the Staff's and Lockhart's adjustments have differed, the Commission finds it appropriate to adopt Staff's Customer Growth adjustment. As the Customer Growth adjustment is based on Net Operating Income and the number of customers, it is appropriate to adopt Staff's adjustment to correspond or match with the calculation of Net Operating Income.

Staff's Customer Growth calculation after the proposed increase is $16,696. Adding the Customer Growth adjustment of $16,696 to the Operating Revenues after the rates and charges approved herein of $12,043,751 and subtracting the Operating Expenses after the rates and charges approved herein of $10,765,308 results in Operating Income for Return of $1,295,139.

8. **Lockhart's original cost rate base allocated to South Carolina retail electric operations for the test year after approved accounting and pro forma adjustments is $11,769,244.**

Pursuant to S.C. Code Ann. Section 58-27-180 (1976), the Commission has the authority after hearing to ascertain and fix the value of the property of an electrical utility. In the context of a ratemaking proceeding, such authority is exercised in the determination of the electrical utility's rate base.

For ratemaking purposes, the rate base is the total net value of the electrical utility's tangible and intangible capital or property value on which the utility is entitled to earn a fair and reasonable rate of return. The rate base, as allocated or assigned directly to Lockhart's retail electric operations, is composed of the value of Lockhart's property used and useful in providing retail electric service to the public, plus construction work in progress, materials and supplies, and allowance for cash working capital. The rate base computation incorporates reductions for the reserve for depreciation and amortization, accumulated deferred income tax, and customer deposits. In accordance with its standard practice, the Audit Department of the Staff conducted an audit and examination of Lockhart's books, and verified all account balances from Lockhart's general ledger, including rate base items, with plant additions and retirements. On the basis of Staff's audit, the pertinent hearing exhibits, and the testimony contained in the record of the hearing, the Commission can determine and find proper balance for the components of Lockhart's rate base, as well as the propriety of related accounting adjustments.

For ratemaking purposes, this Commission has traditionally determined the appropriate rate base of the affected utility at the end of the test year period. Determination of a utility's rate base on a "year end" basis serves to enhance the timeliness of the effect of such action and preserves the reliance on historical and verifiable accounts without resort to speculative or projected figures. With this reasoning in mind, the Commission finds it most reasonable to retain its practice of evaluating the issues of the instant proceeding founded on a rate base for Lockhart's retail electric operations as of August 31, 1999.

When the rate base has been established, Lockhart's total operating income for return is applied to the rate base to determine what adjustments, if any, to the present rate structure are necessary to generate earnings sufficient to produce a fair rate of return. The rate base should reflect the actual investment made by investors in Lockhart's property and the value upon which the investors will receive a return on their investment.
By its Application, Lockhart stated its Original Cost Year-end Rate Base for South Carolina retail operations as $11,737,294. (Application, Attachment A4.) According to Lockhart witness Anderson, this amount reflects a 50.5% increase over Lockhart's retail rate base in 1991, the cost basis year of Lockhart's last rate case. Lockhart witness Anderson testified that Lockhart had made investments in three large categories: (1) to improve efficiencies and/or control or reduce costs; (2) to provide for customer growth and improve service, and (3) to replace obsolete and non-Y2K compliant equipment. Additionally, Lockhart was required by FERC to re-license its hydro facility. (Prefiled Testimony of Anderson, p. 2, ll. 1-11; Hearing Exhibit No. 1, Exhibit LSA-1.)

As to specific improvements made by Lockhart which Lockhart proposes to include in its rate base, Lockhart witness Inman provided information regarding rate base expenditures. In the Production area, Lockhart made investment in a new trashrake system and in the rewinding of generators. With regard to Transmission plant investment, Lockhart made investment in transmission station upgrades, replacing obsolete transformers with more energy efficient, low loss equipment, and installing radio-controlled switches to improve system operations and to provide quicker response time. Transmission system expenditures have also been made in order to extend the system to accommodate customer growth as well as investment to upgrade older sections of transmission lines. Distribution expenditures have been made in three areas: (1) cost reduction and efficiency improvement, (2) customer growth, and (3) obsolescence and Y2K compliance. According to Mr. Inman, Lockhart has made expenditures for distribution lines for general extensions of the distribution system due to growth and for upgrades throughout the entire distribution system. Lockhart spent additional funds in new station construction to serve increasing customer growth and also spent funds on station upgrades, including transformer replacement, capacitor installation, and other system improvements. In the area of General Plant, Lockhart invested in new equipment to replace an obsolete computer system and the purchase of an integrated utility accounting system. According to Witness Inman, Lockhart's retail rate base has increased from $7,794,301 as of November 30, 1991, to $11,737,294 as of August 31, 1999. (Prefiled Testimony of Inman, p.1, l.1 – p.4, l. 15; Hearing Exhibit 3.)

(a) **Annualized Depreciation Expense** - To the per book South Carolina retail electric rate base of $11,737,294 at August 31, 1999, Lockhart and the Staff proposed certain adjustments. Both Lockhart and Staff proposed an adjustment of ($11,817), or ($10,658) attributable to South Carolina retail operations, to adjust for annualized depreciation expense. (Prefiled Testimony of Scott, p. 8, ll. 14-16; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 10 of 12.) The Commission adopts the proposed adjustment as this adjustment increases Accumulated Depreciation for the adjustment to Depreciation expense proposed by the Company and the Staff and previously adopted by the Commission herein.

(b) **Capitalized Wage Increase** - Staff also proposed adjustments to Construction Work in Progress ("CWIP") in order to capitalize a portion of the wage increase, and associated fringe benefits and FICA taxes, approved above for hourly and administrative employees. Staff made adjustments of $4,866, of which $3,717 is attributable to South Carolina retail operations, to capitalize a portion of the wage increase; of $1,222, of which $933 is attributable to South Carolina retail operations, to capitalize a portion of the fringe benefits associated with the wage increase; and of $716, of which $547 is attributable to South Carolina retail operations, to capitalize a portion of the FICA taxes associated with the wage increase. Staff made these adjustments to follow the normal booking of wages. A portion of Lockhart's wages, fringe benefits, and FICA taxes are capitalized, that is expenditures are charged to plant rather than expenses, to account for labor costs assigned to capital projects instead of O&M expenses. Staff capitalized 7.48% of the administrative increase and 19.96% of the hourly wage increase. These percentages reflect the actual percentages of time spent by administrative and hourly employees on capital projects during the test year. (Prefiled Testimony of Scott, p. 8, ll. 14-16; Oral Testimony of Scott at Hearing; Hearing Exhibit No. 8, Audit Exhibit A, p.10-11 of 12.) After considering these adjustments, the Commission finds that they should be adopted. The Commission finds that a portion of the wage increase should be capitalized to account for work spent on capital projects.

(c) **Transportation Equipment** - Staff also proposed an adjustment to correct for over-depreciation of Transportation Equipment. Staff's adjustment consisted of a $49,861 adjustment to Accumulated Depreciation, of which $43,034 is attributable to South Carolina retail operations, and an adjustment to CWIP of ($6,516), of which ($5,623) is attributable to South Carolina retail operations. Staff witness Scott stated that during the test year, Depreciation Expense for Transportation Equipment was booked to Accumulated Depreciation and CWIP. According to Staff witness Scott, these adjustments were needed to remove the over-depreciated portion from these accounts. (Prefiled testimony of Scott, p. 9, ll. 1-5; Oral Testimony of Scott at Hearing; Hearing Exhibit No. 8, Audit Exhibit A-1, p. 11 of 12.) In other words, Lockhart was carrying over-depreciated Transportation Equipment on its books. Upon consideration of this adjustment, the Commission finds that the adjustment is reasonable and should be adopted. Depreciation of Transportation equipment should not be continued after the equipment is fully depreciated.

Total Effect of Adjustments to Rate Base - The adjustments adopted above total $31,950. Applying the total of approved adjustments of $31,950 to the per book South Carolina retail rate base of $11,737,294 as of August 31, 1999, results in an adjusted South Carolina retail rate base of $11,769,244.

Therefore, the proper rate base to be used for ratemaking purposes is included in the following table:

ORIGINAL COST RATE BASE
RETAIL ELECTRIC
AUGUST 31, 1999

Gross Plant in Service	$22,034,152
Reserve for Depreciation	(10,114,824)
Net Plant in Service	$11,919,328
Construction Work in Progress (CWIP)	1,099,252
Material and Supplies	166,510
Cash Working Capital Allowance	0
Accum. Def. Income Taxes	(1,343,180)
Customer Deposits	(72,666)
Total Original Cost Rate Base	$11,769,244

9. **The capital structure utilized by the Commission in this proceeding for the determination of the fair overall rate of return is the existing capital structure of Lockhart which is comprised of 100% equity with no debt.**

By its Application and Prefiled Testimony, Lockhart proposed the use of its existing capital structure which is comprised of 100% equity and no debt as of August 31, 1999. (Application, Attachment A-10.) Staff witness, Dr. Spearman, in his analysis of Lockhart's rate of return also used Lockhart's actual capital structure of 100% equity with no debt. (Prefiled Testimony of Spearman. p. 8, l.4, p. 19, ll. 15-18.) As the only evidence before the Commission with regard to analysis of Lockhart's rate of return uses Lockhart's existing capital structure of 100% equity with no debt, the Commission finds that Lockhart's existing capital structure of 100% equity with no debt is the appropriate capital structure on which to base Lockhart's overall rate of return in the present rate case.

10. **The fair rate of return on common equity, which Lockhart should be allowed a reasonable opportunity to earn, is 11.00%.**

One of the principal issues in any ratemaking determination involves the proper earnings to be allowed on the common equity investment of the regulated utility. This Commission has frequently stated that it adheres to no particular theory or methodology for the determination of a fair rate of return on common equity. Rather, the Commission has perceived its function as that of engaging in a careful and reasoned analysis of the theories for application in a practical context.

The landmark decision of the United States Supreme Court in Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923), delineated general guidelines for determining the fair rate of return in utility regulation. In the Bluefield decision, the Court stated

> What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional rights to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable

> at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.
>
> 262 U.S. at 692-3.

During the subsequent years, the Supreme Court refined its appraisal of regulatory precepts. In the frequently cited decision of Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944), the U.S. Supreme Court restated its view thusly

> We held in Federal Power Commission v. Natural Gas Pipeline Co., … [t]hat the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its ratemaking function, moreover involves the making of "pragmatic adjustments." … Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling …
>
> The rate-making process under the [Natural Gas] Act; i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests. Thus we stated in the Natural Gas Pipeline Co. case that regulation does not insure that the business shall produce net revenues. But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on debt and dividends on the stock. … By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.
>
> 320 U.S. at 602-3. (Citations omitted)

The Hope decision thus represented a restatement of the rate of return principles listed by the Court in the earlier Bluefield decision. Moreover, these principles remain as guidance for determining a fair rate of return. For example, the United States Supreme Court in the case of In Re: Permian Basin Area Rate Cases, 390 U.S. 747 (1968) stated "the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for risks they have assumed, and yet provide appropriate protection to the relevant public interest, both existing and foreseeable." In Re: Permian Basin Area Rate Cases at 792.

In the final analysis, the Commission must use its judgment in evaluating the evidence in regard to the cost of common equity, which is a matter within the expertise of the Commission.

Lockhart witness Anderson testified that in his opinion an overall rate of return of 11.25% is a fair and reasonable return for Lockhart. (Prefiled Testimony of Anderson, P. 6, ll. 2-5.) Staff witness Dr. Spearman, the Commission's Research & Planning Administrator, provided testimony on a recommended return on equity that Lockhart could reasonably expect to earn on its regulated electric operations.

Dr. Spearman testified that he used two methodologies, the Discounted Cash Flow ("DCF") analysis and the Capital Asset Pricing Model ("CAPM") analysis, to estimate the cost of equity appropriate for the regulated electric operations of Lockhart. Because Lockhart's common stock is 100% owned by Milliken & Company and is not publicly traded, Lockhart specific data required by the models was not available. Therefore, a proxy group of companies was selected. Dr. Spearman selected the twenty-five companies comprising the Moody's Electric Utility Index. Dr. Spearman properly noted that Lockhart is different in many respects from the companies comprising the

Moody's Electric Utility Index. However, Dr. Spearman also noted that the characteristics that separate Lockhart from the proxy group (i.e. Lockhart is significantly smaller by all measures; Lockhart's capital structure is 100% common equity; Lockhart pays out a lower percentage of earnings on dividends; depending on river flow, Lockhart relies on purchased power to meet from approximately 70% to 85% of its total electricity needs; Lockhart's service area is highly dependent on the very competitive textile industry; and virtually all of Lockhart's revenue and income are from electricity sales, transmission, and distribution), also, with the exception of the capital structure and lower dividend payouts, tend to increase the level of risk faced by Lockhart. Dr. Spearman acknowledged that there are no good proxy companies for Lockhart having readily available public data. However, Dr. Spearman offered that the proxy group selected does provide a spectrum of investor-owned utilities and can be used to evaluate the return on investment investors require from electric utility stocks. (Prefiled testimony of Spearman, p. 5, l. 11 – p. 8, l.23; Hearing Exhibit No. 7.)

Both dividend growth rates and earnings growth rates were utilized in the basic annual constant growth DCF model. The results of the dividend growth provide a floor for the expected return on equity while the results using earnings growth provided a ceiling. Dividend growth rate projections were taken from the Value Line Investment Survey and the Merrill Lynch Global Research Review. Earnings growth rate forecasts were taken from Value Line, Merrill Lynch, and Quicken which provides a composite forecast based on the forecasts of many stock analysts. The average cost of equity using dividend growth ranged between 7.55% and 9.27%. The average cost of equity using earnings growth ranged between 11.61% and 11.71%. (Prefiled testimony of Spearman, p. 11, l. 8 – p. 13, l.21; Hearing Exhibit No. 7.)

Dr. Spearman's CAPM analysis utilized betas reported by Value Line and Merrill Lynch. Those were adjusted betas to reflect the perceived long-term tendency of betas to converge toward the market beta of 1.0. The May-July end-of-month average yield on the 10-year Treasury Bond was used as the risk-free market rate. Based on various measures of total market return, Dr. Spearman determined that a market return in the range of 11.0% to 18.0% could be reasonable. The expected return on equity produced by the CAPM ranged from 7.89% to 12.40% with an average range of 8.95% to 12.05%. (Prefiled testimony of Spearman, p. 13, l. 22 – p. 18, l.10; Hearing Exhibit No. 7.)

Dr. Spearman testified that yields on medium quality (A/BBB), long-term (10+ years) corporate debt were approximately 8.2% at the end of July, 2000. The corresponding yields on utility company debt were about 7.8%. Since the cost of debt is generally lower than the cost of equity, the low end of the expected returns generated by the DCF and CAPM analyses would not be acceptable to investors. The yields on high-end corporate bonds are generally about 12.0% or higher. (Prefiled testimony of Spearman, p. 18, l. 11 – p. 19, l. 4; Hearing Exhibit No. 7.)

Dr. Spearman stated that it could be reasonably assumed that investors might view Lockhart as having medium to high risk. As reasons for the assumption that investors may view Lockhart as having medium to high risk, Dr. Spearman indicated (1) the uncertainty facing the electric industry particularly concerning electric restructuring, (2) the very small size of Lockhart compared to the proxy group, as risk generally increases as size decreases, and (3) the heavy dependence on the textile industry in Lockhart's service territory. Dr. Spearman also stated that Lockhart's strong financial position resulting from its 100% equity capital structure would tend to lower the risk premium. Dr. Spearman also offered that historically Lockhart's return on equity has tended to track fairly closely the return on equity for the Moody's Electric Index. Based on his analysis, Dr. Spearman testified that he would consider a return on equity in the range of 10.75% to 11.75% as reasonable for Lockhart. (Prefiled testimony of Spearman, p. 19, l.6 – p. 19, l. 23; Oral testimony of Spearman at Hearing; Hearing Exhibit No. 7.)

The Commission recognizes the legal principle that the Company be allowed an opportunity to earn a fair return sufficient to enable it to continue to meet its service obligations and to maintain its financial integrity. No party challenged Dr. Spearman's recommended range. In considering a reasonable rate of return on equity for Lockhart, the Commission is mindful that Lockhart's size presents risks for the Company. Thus, the Commission does not believe that the extreme low end of Dr. Spearman's recommended range is appropriate. Further, the Commission recognizes that Lockhart, by virtue of its strong financial position due to its 100% equity capital structure, may be viewed as a secure company, a fact which usually lowers a risk premium and mitigates against the high end of Dr. Spearman's recommended range. In light of the evidence presented in this case, the Commission finds that the fair and proper return on common equity is 11.00%. An 11.00% return on common equity is within the range recommended by Dr. Spearman and is only slightly lower than the return testified to by Lockhart witness Anderson and requested in the Application. The Commission considers this rate to represent a reasonable expectation for the equity owner. Further, this Commission concludes that a rate of return on equity of 11% is sufficient to protect the financial integrity of Lockhart, to preserve the property of the investor, and to permit Lockhart to continue to provide reliable service to present and future customers at reasonable rates.

11. **Based upon the specific findings and conclusions herein, Lockhart's annual revenue requirement for its South Carolina retail electric operations is $12,043,751, which will allow Lockhart a reasonable opportunity to earn an 11.00% rate of return on its jurisdictional rate base which the Commission finds just and reasonable. The rates approved herein are intended to produce revenues for South Carolina retail electric operations of $793,797, after accounting and pro forma adjustments.**

An important function of ratemaking is the determination of the overall rate of return which the utility should be granted. One definition of "rate of return" is

> For regulatory purposes, the rate of return is the amount of money earned by a public utility, over and above operating costs, expressed as a percentage of the rate base. In other words, the rate of return includes interest on long-term debt, dividends on preferred stock and earnings on common stock (including surplus or retained earnings). As Garfield and Lovejoy have put it, "the return is that money earned from operations which is available for distribution among the various classes of contributors of money capital. In the case of common stockholders, part of their share may be retained as surplus. The important point to note is that the rate of return includes profit (in the traditional sense), as well as interest on debt capital and dividends on preferred stock.
>
> Phillips, The Regulation of Public Utilities (1993), pp. 375-6.

The amount of revenue permitted to be earned by the Company through its rate structure depends upon the rate base and the allowed rate of return on the rate base. As previously discussed, the primary issue between the regulated utility and the regulatory body most frequently involves the determination of a reasonable return on common equity. Although the determination of the return on common equity provides the necessary component from which the rate of return on rate base can be derived, the overall rate of return, as set by this Commission, must also be fair and reasonable.

The Commission has found that Lockhart's capitalization ratio as of August 31, 1999, is appropriate and should be used in this proceeding. (See, Finding of Fact No. 9 and the discussion therein.) For the purposes of this proceeding, the Commission finds the proper cost rate for Lockhart's common equity capital to be 11.00%. (See, Finding of Fact No. 10 and the discussion therein.) Using these findings, the overall rate of return on rate base for Lockhart is 11.00% and may be derived as computed in the following table:

COMPONENT OF CAPITAL STRUCTURE	RATIO (%)	COST RATE (%)	OVERALL RATE (%)
Common Equity	100.00	11.00	11.00
TOTAL	100.00		11.00

Since the capital structure of Lockhart is 100% equity, the return on common equity is also the overall rate of return on rate base. The Commission finds that a return on rate base of 11.00% is fair and reasonable. However, Lockhart must insure that its operating and maintenance expenses remain at the lowest level consistent with reliable service and exercise appropriate managerial efficiency in all phases of its operations. Using the approved Operating Expenses of $10,765,308 (See, Finding of Fact No. 6), the total retail Operating Income for Return of $1,295,139 (See, Finding of Fact No. 7), and the 11.00% rate of return on rate base, the Commission finds that Lockhart will require an annual revenue requirement of $12,043,751 in order to have an opportunity to earn its herein approved rate of return on rate base of 11.00%. To achieve an annual revenue requirement of $12,043,751, the Commission finds that Lockhart will require revenues from South Carolina retail electric operations of $793,797. The annual revenue requirement is illustrated by the following table:

SOUTH CAROLINA RETAIL ELECTRIC

	AS ADJUSTED	EFFECT OF PROPOSED INCREASE	AFTER PROPOSED INCREASE
	$	$	$
Operating Revenues	11,249,954	793,797	12,043,751
Less: Operating Expenses	10,467,560	297,748	10,765,308
Net Operating Income	782,394	496,049	1,278,443
Add: Customer Growth	10,218	6,478	16,696
Total Income for Return	792,612	502,527	1,295,139
Total Original Cost Rate Base	11,769,244	0	11,769,244
Rate of Return on Rate Base	6.73%		11.00%

12. **The cost of service methodology, rate design, and rate schedules as proposed by Lockhart are appropriate and should be adopted for the purpose of this proceeding.**

The Commission is responsible for the determination of the specific rates and the development of the rate structure that will yield the required revenues. It is generally accepted that proper utility regulation requires the exercise of control over the rate structure to ensure that equitable treatment is afforded each class of customer.

The Commission's statutory responsibility to fix just and reasonable rates has been exercised by the recognition of the objective to provide a utility a fair opportunity to earn a reasonable return which meets the established revenue requirement and equitably apportions the revenue responsibility among the classes of service. In our discharge of that responsibility, we are mindful of the following criteria:

> (a) The revenue requirement or financial need objective, which takes the form of a fair return standard with respect to private utility companies;
> (b) The fair cost apportionment objective, which invokes the principle that the burden of meeting total revenue requirements must be distributed fairly among the beneficiaries of the service; and
> (c) The optimum use or customer rationing objective under which the rates are designed to discourage the wasteful use of public utility services while promoting all use that is economically justified in view of the relationships between cost incurred and benefits received.

Bonbright, Principles of Public Utility Rates (1961, page 292).

These criteria have been consistently observed by this Commission and again are utilized in this matter.

The cost of supplying electricity to different customers is a function of many factors and variables. The allocation of these costs among the different classes of customers represents a complex task, since many of the total costs of producing energy are common to all customers. The procedure generally used by this Commission in analyzing utility costs in the context of the review of rate design provides for the assignment of the distribution of total costs among three major categories based on (1) costs that are a function of the total number of customers, (2) costs that are a function of the volumes of the service supplied or energy costs, and (3) costs that are a function of the service capacity of plant and equipment in terms of capability of carrying hourly or daily peak loads or demand costs.

In concluding that rates should be based on cost of service principles, the Commission reflects the economic theory that regulation is intended to act as a surrogate for competition by insuring that each rate that is charged for electricity is fair and reasonable, that is, that utility rates are maintained at the level of costs, including a fair return on capital. By incorporating cost of service principles, the Commission provides for rates and charges which are designed to promote equity, engineering efficiency (cost minimization), conservation, and stability.

The foundation for an equitable and efficient cost-based rate structure is a cost study which accounts for the variables and factors from which are derived the cost of supplying electricity to different classes of customers. The cost of service study not only identifies the total cost of service and thereby measures the profitability of the utility but also identifies the cost function and class of service and so measures the compensability of service to any one class. Furthermore, the cost of service study is used to assess the propriety of any one particular rate structure in the design of rates. In a sense, a cost of service study functions as a regulatory guide by which the ratemaker can determine the existing rate of return to each class and the manner and extent to which it should be adjusted to achieve cost-based rates.

Lockhart sponsored cost studies in support of its proposed rates and charges. Lockhart owns and operates an electric system which provides electric energy to approximately 9,233 retail customers, including 5,128 residential customers, 979 commercial customers, 13 industrial customers, and 3,113 lighting customers. Lockhart also serves one wholesale customer. Each of these classes of customers contributes different load characteristics and resulting cost-to-serve. In order to determine that each customer class is providing adequate revenue to cover the cost-to-serve, a cost-of-service study was performed. This study was designed to separate the Company's revenues, expenses and rate base into proportionate shares for each rate class and jurisdiction. In order to accomplish the goal of distributing the revenues, expenses, and rate base categories, Lockhart utilized the "12 Coincident Peak" ("12 CP") method of allocation for the demand-related items. Energy-related items were allocated based on the energy used by each class during the test period, and for customer-related items, the number of customers in each class was used to determine the allocations. In all cases where revenues, expenses, or rate base items were for a specific customer, that item was directly assignable. (Hearing Exhibit No. 10, Part A, p. 1.)

According to Lockhart witness Parmelee, the methodology and format of the cost of service studies filed in the instant proceeding are almost identical to those of the previous Lockhart filing with one exception. The exception is the allocation method used to allocate the production demand-related costs and transmission costs. Previous Lockhart cost of service studies employed the Average and Excess Demand method, whereas the instant study uses the 12 CP method. Witness Parmelee offered that the 12

CP is now the logical method for allocating demand-related costs. Witness Parmelee explained that the major expense allocated with this factor is the demand component of purchased power cost. This component is determined by the Duke Power Resale Service Schedule, which in previous test years billed demand charges based on a demand ratchet, which weighed Lockhart's higher summer demands. Duke Power has now revised the definition of the billing demand in their Resale Service rate and now uses Lockhart's monthly coincident peak demand. (Testimony of Parmelee, p. 4, l. 20 – p. 5, l. 16.) No party took exception with Lockhart's proposed method or advocated another method.

The cost of service study was the basis for all proposed rates. Although the cost of service study revealed differences in the rates of return paid by the different rate classes, bringing all classes to equal rates of return would place undue burden on some classes. (See, Prefiled Testimony of Parmelee, p. 5, l. 17 – p.7 l. 17.) Lockhart proposed to keep Industrial revenues on the same 14.08% rate of return which was used in the previous rate case and to set Residential revenues at a level which would reduce the residential increase below 8%. Further, Lockhart proposed to increase Commercial revenues so that the overall retail rate of return is 11.25%. Lockhart's proposal results in an Industrial rate of return of 14.08%, a Residential rate of return of 9.69%, a Commercial rate of return of 12.78%, and Lighting classes rate of return of 11.25%. (Prefiled Testimony of Parmelee, P. 6, ll. 6-15.) No party offered any alternative to Lockhart's proposed returns for the classes. In fact, Staff agreed with Lockhart that bringing all classes to equal rates of return could create an undue burden on some classes, such as Residential. Staff considers a move toward equal rates of return, rather than attempting to equalize rates of return in a single move, an acceptable means of accomplishing the objective of alleviating or minimizing possible undue burden and rate shock. (Prefiled Testimony of Watts, p. 2, ll. 23-27; Hearing Exhibit No. 10, Part C, p. 4.) Lockhart has also applied the increase in a manner that results in higher returns for the classes considered to be at greater risk. For example, the Industrial class return is higher than the average since the Industrial class is perceived to be at more risk because it is composed of predominantly textile or textile-related businesses which are more vulnerable in part due to pressure from foreign competition. (Prefiled testimony of Watt, p. 2, l. 27 – p. 3, l. 2; Prefiled Testimony of Anderson, p. 3, ll. 4-18.) Therefore, based on the reasoning propounded by Lockhart and the Staff, the Commission adopts Lockhart's proposed rates of return by classes as the basis on which to design the new rate schedules.

As a result of the adjustments approved herein, the base rate Purchased Power level to be included in the approved rates 3.2672 cents per kilowatthour. (Prefiled Testimony of Watts, p. 5, ll. 6-11.)

The Commission hereby directs Lockhart to file rates which produce the additional revenue requirement of $512,882, which is found fair and reasonable herein, and to distribute the additional revenue responsibility consistent with the distribution approved in the preceding paragraph. Based upon the Commission's determinations in this Order, the additional annual revenues produced by the rates and charges approved in this proceeding are illustrated in the following table:

CLASS OF SERVICE	APPROVED INCREASE
Residential Service Class	$358,279
Commercial Service Class	39,978
Industrial Service Class	68,075
Lighting Service Class	41,192
Rate Revenue Total	$507,524
Other Revenue	5,358
TOTAL JURISDICTION (Retail Electric)	$512,882

IT IS THEREFORE ORDERED THAT:

1. Lockhart shall implement the rate designs and rate schedules for service as proposed by Lockhart to be effective for service rendered on or after the date of this Order.

2. Lockhart shall file within ten (10) days from the date of this Order, rate schedules in accordance with the findings contained herein.

3. In future filings which include adjustments involving river flow, Lockhart shall support its results by use of an appropriate model based on standard engineering practices to include a statistically representative period of record while providing adequate consideration to modified run-of-river operations and downstream water release requirements.

4. This Order shall remain in full force and effect until further Order of the Commission.

BY ORDER OF THE COMMISSION:

William Saunders

Chairman

ATTEST:

Gary E. Walsh

Executive Director

(SEAL)